

Franchise Tax Board**ANALYSIS OF ORIGINAL BILL**

Author: McLeod Analyst: Gail Hall Bill Number: SB 1289
Related Bills: See Legislative History Telephone: 845-6111 Introduced Date: February 19, 2008
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Workers' Compensation Self-Insured Groups Would File In A Manner Similar To Cooperatives For State Tax Purposes

SUMMARY

This bill would change the method a worker's compensation self-insured group (SIG) uses to determine its corporation franchise and income tax.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to alleviate the eroding of funds as a result of taxing member contributions that have been earmarked for future payments to injured workers.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and would be operative for taxable years beginning on or after January 1, 2008. The bill specifies that a SIG may elect to apply the provisions of this bill to all taxable years for which a taxpayer may file a claim for refund. In addition, the bill contains a "no inference" clause with respect to the provisions added by this bill, and legislative findings and declarations that the provisions fulfill a public purpose.

POSITION

Pending.

PROGRAM BACKGROUND

Workers' compensation laws are designed to ensure that employees who are injured or disabled on the job are provided with fixed monetary awards, eliminating the need for litigation. These laws also provide benefits for dependents of those workers who die because of work-related accidents or illnesses. Some laws also protect employers and fellow workers by limiting the amount an injured employee can recover from an employer and by eliminating the liability of co-workers in most accidents. State workers' compensation statutes establish this framework for most employment. Federal statutes are limited to federal employees or those workers employed in some significant aspect of interstate commerce.

Board Position:

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_____ N	_____ OUA	_____ <u>X</u> PENDING

Department Director**Date**

Selvi Stanislaus

4/01/08

Current state law requires all employers to purchase or provide workers' compensation benefits for their California employees. Employers may finance their liability for workers' compensation benefits by one of three methods: (1) self-insurance, (2) private insurance, or (3) state insurance. Employers wishing to self-insure must first obtain consent from the Department of Industrial Relations (DIR).

In 1993, the Legislature authorized the establishment of private-industry SIGs to address employers' workers' compensation costs. Under state law, two or more employers with the same industry code may form a nonprofit mutual benefit corporation for the purpose of self-insuring its workers' compensation coverage. As of January 31, 2008, there were 27 self-insured groups listed on the roster of the Office of Self-Insurance Plans.¹

The DIR adopted the following regulatory requirements for SIG formation:

- SIGs must maintain an aggregate net worth of \$5 million and average annual consolidated group net income greater than \$500,000.
- SIGs must have sufficient income to fund the following items:
 - Group self-insurer's actuarially projected claim liabilities at the 80% confidence level,
 - Expected payment of administrative expenses to operate the group self-insurer's business operations, and
 - Required security deposit.
- Group members must submit two years of audited financial statements and affiliate members must submit one year of reviewed financial statements.
- Members must agree to share risk jointly and severally.
- Members must undergo a feasibility study and submit an operating plan for approval by the state.

SIGs are created by employer members to help manage the payments of workers' compensation benefits in a timely, efficient, and cost-effective manner. Members contribute into the fund and SIGs pay each policy year's expenses (administrative costs, claims, etc.) from collected funds. The contributions are comparable to the insurance premiums paid by insured employers to insurance companies.

In the event that member funds collected within any calendar year are insufficient, the SIGs will assess employer members for additional contributions to meet the funding requirements for workers' compensation.

Members will ordinarily treat contributions and assessments paid to SIGs as an expense that is deducted from each member's taxable income for the year in which it is paid or incurred. Excess contributions which are not required for reserves can be returned to the members as a dividend. A refund of excess contributions will be recognized by the members as income for the year in which it is received or accrued.

¹ <http://www.dir.ca.gov/SIP/rosters.htm>

ANALYSIS

FEDERAL LAW

Under current federal law, SIGs are taxed the same as insurance companies. Gross premiums are reported as income and taxed at the corporate rate and SIGs are allowed a deduction on discounted unpaid losses. The practical effect of discounting spreads the deduction of incurred losses over a number of years to match investment earnings on losses incurred but not yet paid.²

STATE LAW

Unlike federal tax law, the state taxes SIGs as corporations subject to the franchise or income tax rate of 8.84% instead of being taxed as insurance companies under the gross premiums tax. For example, contributions paid by employers to the group self-insurer and income earned on investments are gross receipts and includable as income. Compensation paid to injured employees, accrued unpaid claims, and expenses relating to the amounts paid or incurred for injured employees and investments are deductions from income.

California allows associations organized and operated in whole or in part on a cooperative or mutual basis to deduct all income arising out of business activities conducted with members and nonmembers, provided the business with nonmembers is conducted on a nonprofit basis.³ All income arising from nonbusiness activities conducted by members and nonmembers is taxable using the corporation tax rules.

THIS BILL

SB 1289 would specify that a SIG would use a method similar to cooperatives to calculate its corporation franchise or income tax with the following exceptions:

- The amount of deduction normally allowed to a cooperative shall be limited to the lesser of the actual contributions paid to the SIG by the members, net of contributions refunded to the members, or the amount of funding of workers' compensation claims determined at least every other year⁴ by the assigned actuary.
- No deduction shall be allowed for compensation⁵ paid to injured employees, or for claims, losses, and expenses attributable to amounts deductible (contributions) .

² Internal Revenue Code section 831 and 832.

³ Revenue and Taxation Code section 24405(a).

⁴ Section 15481 of Title 8 of the California Code of Regulations.

⁵ Section 3207 of the California Labor Code.

In addition, SB 1289 includes the following provisions:

- A SIG would be prohibited from filing on a combined basis with another corporation(s), except the Franchise Tax Board may combine a SIG with another corporation(s) to properly reflect the income or loss of the combined unitary group.
- A SIG is defined as a private, non-profit, mutual benefit corporation⁶ that has secured a certificate of consent from the Director of Industrial Relations⁷ to self-insure two or more private employers in the same industry under the California workers' compensation statutes and regulations.

LEGISLATIVE HISTORY

SB 420 (McLeod, 2007/2008) would have allowed a SIG to make an election to deduct all contributions or assessments accrued or received during the taxable year from current income, or deduct the losses, expenses, and dividends that are paid during the taxable year from contributed funds. SB 420 did not pass the Senate by the constitutional deadline, therefore it was returned to the Secretary of Senate.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York have similar established groups to help employers secure funds and pay workers' compensation claims; however, these states, other than Massachusetts, tax similar self-insured groups as insurance companies subject to a gross premiums tax. Massachusetts subjects SIGs to an annual assessment, to be paid quarterly.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

⁶ Subdivision (s) of Section 15201 of Title 8 of the California Code of Regulations.

⁷ Subdivision (b) of Section 3700 of the California Labor Code.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue losses.

Estimated Revenue Impact of SB 1289 Effective for All Open Tax Years Assumed Enactment After 6/30/08		
07/08	08/09	09/10
-\$1,000,000	-\$500,000	-\$250,000

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

This bill would allow SIGs a deduction for contributions received less any refunds made to group members. All investment income of SIGs would continue to be subject to tax. SIGs are currently taxed on contributions that exceed liabilities incurred during a year, even when the liability extends over a number of years. The revenue impact of this bill is dependent on the amount of income taxes paid on excess contributions in any tax year where the statute of limitations has yet to expire.

Based on a sample of tax files for identifiable SIGs, it is estimated that all SIGs paid slightly less than \$300,000 in taxes for tax year 2005. It is assumed that as much as 80% of taxes paid are related to excess contributions and the remainder is assumed to be investment income that would continue to be taxed. For a single tax year, the revenue impact of excluding excess contributions from taxation would total approximately \$240,000 ($\$300,000 \times 80\%$). The reduction in tax liability for tax years 2008 and 2009 would impact fiscal year 2008/2009.

Assuming that this bill is enacted after June 30, 2008, tax year 2004 would be the earliest year with an active statute of limitations, expiring on April 15, 2009. Assuming that \$240,000 is the average loss for each tax year from 2004 through 2007, the revenue impact for prior tax years would total \$960,000 ($\$240,000 \times 4$). It is anticipated that amended returns would be filed during fiscal year 2008/2009. Because these returns are associated with prior liability years, this revenue must be accrued back one year to fiscal year 2007/2008.

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